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ABSTRACT

It is helpful to know how to read a company's annual report if an individual is considering going to work for the company, investing in it, or selling to it. When reading an annual report, start at the back with the report of the independent certified public accountant and the footnotes. These can provide information that is not readily apparent from the figures in the report. Next, turn to the letter from the chairman. This should tell how the company fared this year and why, as well as giving insights into the company's future. Now it is time to dig into the numbers. One source is the balance sheet which offers information on the company's assets and liabilities. Important numbers to watch are stockholders' equity, long-term debt, and the ratio between these numbers. A second basic source of numbers is the income statement. The first number to look for here is net sales and the rate at which sales are changing. Watch out for net earnings per share; it can be misleading. Don't be smug about net earnings until finding out what is behind them and what might happen next year. The most important thing of all is to compare the annual report to past reports. (DC)

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HOW TO READ AN ANNUAL REPORT
POWER OF THE PRINTED WORD

by

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International Paper Company

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TO THE EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)."

How to read an annual report

By Jane Bryant Quinn

International Paper asked Jane Bryant Quinn, business commentator for the CBS-TV Morning News, columnist for Newsweek, and author of Everyone's Money Book, to tell how anyone can understand and profit from a company's annual report.

To some business people I know, curling up with a good annual report is almost more exciting than getting lost in John le Carré's latest spy thriller.

But to you it might be another story. "Who needs that?" I can hear you ask. *You* do—if you're going to gamble any of your future *working* for a company, *investing* in it, or *selling* to it.

Why should you bother?

Say you've got a job interview at Galactic Industries. Well, what does the company do? Does its future look good? Or will the next recession leave your part of the business on the beach?

Or say you're thinking of investing your own hard-earned money in its stock. Sales are up. But are its profits getting better or worse?

Or say you're going to supply it with a lot of parts. Should you extend Galactic plenty of credit or keep it on a short leash?

How to get one

You'll find answers in its annual report. Where do you find *that?* Your library should have the annual reports of nearby companies plus leading national ones. It also has listings of companies' financial officers and their addresses so you can write for annual reports.

So now Galactic Industries' latest annual report is sitting in front of you ready to be cracked. How do you crack it?

Where do we start? *Not* at the front. At the *back!* We don't want to be surprised at the end of *this* story.

Start at the back

First, turn back to the report of the *certified public accountant.* This third-party auditor will tell you right off the bat if Galactic's report conforms with "generally accepted accounting principles."

Watch out for the words "subject to." They mean the financial report is clean *only* if you take the company's word about a particular piece of business, and the accountant isn't sure you should. Doubts like this are usually settled behind closed doors. When a "subject to" makes it into the annual report, it could mean trouble.

What else should you know before you check the numbers?

Stay in the back of the book and go to the *footnotes.* Yep! The whole profits story is sometimes in the footnotes.

Are earnings down? If it's only because of a change in accounting, maybe that's good! The company owes less tax and has more money in its pocket. Are earnings up? Maybe that's bad. They may be up because of a special windfall that won't happen again next year. The footnotes know.

For what happened and why

Now turn to the *letter from the chairman.* Usually addressed "to our stockholders," it's up front, and *should* be in more ways than one. The chairman's tone reflects the personality, the well-being of his company.

In his letter he should tell you how his company fared this year. But more important, he should tell you *why.* Keep an eye out for sentences that start with "Except for..." and "Despite the..." They're clues to problems.

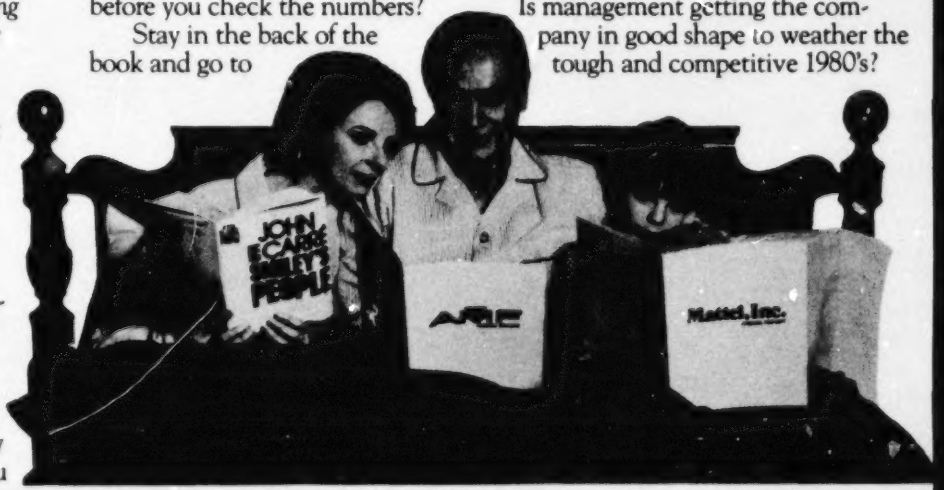
Insights into the future

On the positive side, a chairman's letter should give you insights into the company's future and its *stance* on economic or political trends that may affect it.

While you're up front, look for what's new in each line of business. Is management getting the company in good shape to weather the tough and competitive 1980's?

Now—and no sooner—should you dig into the numbers!

One source is the *balance sheet.* It is a snapshot of how the company stands at a single point in time. On the left are *assets* – everything the company owns. Things that can



"Reading an annual report can be (almost) as exciting as a spy thriller—if you know how to find the clues. I'll show you how to find the most important ones here."

quickly be turned into cash are *current assets*. On the right are *liabilities*—everything the company owes. *Current liabilities* are the debts due in one year, which are paid out of current assets.

The difference between current assets and current liabilities is *net working capital*, a key figure to watch from one annual (and quarterly) report to another. If working capital shrinks, it could mean trouble. One possibility: the company may not be able to keep dividends growing rapidly.

Look for growth here

Stockholders' equity is the difference between total assets and liabilities. It is the presumed dollar value of what stockholders own. You want it to grow.

Another important number to watch is *long-term debt*. High and rising debt, relative to equity, may be no problem for a growing business. But it shows weakness in a company that's leveling out. (More on that later.)

"For inside information, an annual report is second only to meeting with the brass behind closed doors. Come on in!"

The second basic source of numbers is the *income statement*. It shows how much money Galactic made or lost over the year.

Most people look at one figure first. It's in the income statement at the bottom: *net earnings per share*. Watch out. It can fool you. Galactic's management could boost earnings by selling off a plant. Or by cutting the budget for research and advertising. (See the footnotes!) So don't be smug about net earnings until you've found out how they happened—and how they might happen next year.

Check net sales first

The number you *should* look at first in the income statement is *net sales*. Ask yourself: Are sales going *up at a faster rate* than the last time around? When sales increases start to slow, the company may be in trouble. Also ask: Have sales gone up faster than inflation? If not, the company's *real* sales may be behind. And ask yourself once more: Have sales gone down because the company is selling off a losing business? If so, profits may be soaring.

(I never promised you that figuring out an annual report was going to be easy!)

Get out your calculator

Another important thing to study today is the company's debt. Get out your pocket calculator, and turn to the balance sheet. Divide long-term liabilities by stockholders' equity. That's the *debt-to-equity ratio*.

A high ratio means that the company borrows a lot of money to spark its growth. That's okay—*if* sales grow, too, and *if* there's enough cash on hand to meet the payments. A company doing well on borrowed money can earn big profits for its stockholders. But if sales fall, watch out. The whole enterprise may slowly sink. Some companies can handle high ratios, others can't.

You have to compare

That brings up the most important thing of all: *One* annual report, *one* chairman's letter, *one* ratio won't tell you much. You have to compare. Is the company's debt-to-equity ratio better or worse than it used to be? Better or worse than the industry norms? Better or worse, after this recession, than it was after the last recession? In company-watching, *comparisons are all*. They tell you if management is staying on top of things.

Financial analysts work out many other ratios to tell them how the company is doing. You can learn more about them from books on the subject. Ask your librarian.

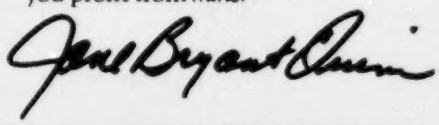
But one thing you will *never* learn from an annual report is how much to pay for a company's stock. Galactic may be running well. But if investors expected it to run better, the stock might fall. Or, Galactic could be slumping badly. But if investors see a better day tomorrow, the stock could rise.

Two important suggestions

Those are some basics for weighing a company's health from its annual report. But if you want to know *all* you can about a company, you need to do a little more homework. First, see what the business press has been saying about it over recent years. Again, ask your librarian.

Finally, you should keep up with what's going on in business, economics and politics here and around the world. All can—and will—affect you and the companies you're interested in.

Each year, companies give you more and more information in their annual reports. Profiting from that information is up to you. I hope you profit from *mine*.



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